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SUBJECT: ECUADOR RE-ENTERS BOND MARKET

1. Summary. Ecuador successfully placed about \$650 million in bonds on December 7, marking its first return to the private international finance market since its 1999 default. According to Minister of Economy and Finance Magdalena Barreiro, Ecuador will use the proceeds to buy back higher priced debt, with a potential savings of \$120 million over the next 10 years. Venezuela, which originally said it would purchase about \$300 million of the bonds, ended up with only about \$25 million. Ecuador, with the recent appointment of a new Central Bank Board is also closer to receiving a \$400 million loan from the FLAR. As a result, analysts are saying that Ecuador could be over-financed by as much as \$500 million in 2006. End Summary.

Back in the Market

2. Ecuador tried to return to the international debt market last April, but stopped those efforts when former President Gutierrez was removed from office. That would have marked Ecuador's first return to the international debt markets after its 1999 default. President Palacio's first Economy Minister (and now presidential candidate) Rafael Correa halted the effort. Correa's tenure was short-lived. International financial markets welcomed his replacement, Magdalena Barreiro, and the marked change in direction from Correa's statist economic policies to more sustainable ones.

3. Demand was strong for the bond offer on December 7. The 10 year bonds offered a yield of 10.75% (9.375% coupon). Of the approximately \$1.5 billion booked, Ecuador sold \$650 million worth of bonds. Venezuela, which originally touted it would purchase \$300 million of the bonds, purchased only about \$25 million.

More Financing on its Way

4. Congress recently approved a new board of directors for the Central Bank Board. Most believe this was the last remaining hurdle for Ecuador to receive a \$400 million loan from the Latin America Reserve Fund (FLAR). Ecuador will use the FLAR funds and the 2015 bond proceeds to buy back some of its outstanding 2012 bonds (which have a 12% interest rate) and local treasury notes (CETES). Barreiro estimates that the buybacks of some of the 2012 bonds and CETES could save Ecuador \$120 million in interest costs over the next 10 years.

Over-financed in 2006?

5. Financial analysts at Credit Suisse First Boston (CSFB) estimate that Ecuador could be over financed by as much as \$500 million in 2006. There are, however, certain risks that must be considered. CFSB reports that for every \$1/barrel decline in oil prices, government revenues fall by \$30 million on an annualized basis. Thus, a notable decline in oil prices could drastically effect the fiscal situation. There have been, and will continue to be in the 2006 election season, pressure on the GOE to spend more on social and other development projects, adding more fiscal pressure. The government continues to subsidize the energy sector and might have to spend hundreds of millions more to finance investments in the electricity generation and distribution over the next several years to avoid energy shortages.

Comment

6. Ecuador's return to the international debt market and eventual FLAR loan should ease some of the fiscal pressure on the GOE, at least in 2006. Still, new financing sources do not address the fundamental problems of political instability and poor investment conditions in the country. Eventually, Ecuador will have to address these problems, and hopefully it will do so before cyclical factors such as a decline in oil prices or demand for emerging market debt recur.

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